Scottish Independence

Commentary on the key challenges facing an independent Scotland within financial services

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Introduction

The Institute and Faculty of Actuaries is a professional membership organisation. It is not our place to tell our members, clients or customers how they should vote in any referendum on Scottish independence. As a result, we do not side with any political group on this (or any other) political question. As a profession we do however have a role in serving the public interest. Our intention in producing this report is therefore to highlight issues on this subject that might affect our members, the sectors they work in and their clients and customers.

In May the Institute and Faculty of Actuaries (IFoA), published a list of questions that its members felt should be answered ahead of the referendum and which could have a significant impact on our members, their clients and customers. These questions fall into five key areas:

- **Single market** – what will happen to the UK's current single market for financial services in an independent Scotland?
- **Regulation -** what regulation and protection schemes will there be for policyholders and other stakeholders in financial services in an independent Scotland?
- **Taxation** – how different would taxation be in an independent Scotland and what impact would this have on the pensions, insurance and investment markets?
- **Public sector pensions, state pensions and other social security benefits** – what will these look like and how will these be financed in an independent Scotland?
- **Europe** – EU-driven legislation is widespread in the pensions, insurance and investment markets with more in the pipeline. The future status of an independent Scotland in Europe is therefore key to the operation of these markets in Scotland.

This paper is the result of the IFoA's more detailed considerations of the questions raised. It follows the recent document published by the Scottish Government; "Pensions in an Independent Scotland" and in so doing references the outline for pensions in Scotland should a "yes" vote lead to independence.

It should be noted that this paper is framed within the limitations of what is known about two significant areas of uncertainty, each of which would have a big impact on the provision of financial services in Scotland:

1. What will be the status within Europe of an independent Scotland? The IFoA will not comment in the continuing debate on the likely outcome of this matter; however, knowing the status of Scotland would provide clarity and answers to some of the questions raised in this paper. In particular, membership of the European Union would have a significant impact on the funding requirements for any cross-border pension schemes. This paper considers this point and notes the potential significant impact of increased pension funding on economic growth, or, alternatively the potential acceleration of scheme closures in reducing future retirement incomes.

2. What will Scotland's currency post-independence be? It would be speculative to consider each option in detail, (Euro, Sterling or 'Scottish pound') but, without a definitive answer, clarity of the post-independence situation simply cannot be provided on so many issues affecting financial services including the questions raised in this paper.

The state pension in an independent Scotland

The Scottish Government published its proposals for the State Pension in its 2013 report "Pensions in an Independent Scotland". This paper considers four elements of State Pensions:

- The calculation of pension amounts and their administration
- The state pension age
- Increases to the state pension
- The amount of the state pension

The calculation of pension amounts and their administration

It is important to emphasise that state pensions are unfunded. National Insurance (NI) contributions do not form a pool of assets from which State Pensions are paid. The money to pay pensions comes from within the total revenues received from all forms of taxation, including NI. As such any unexpected increase to the total pension bill is met by reducing Government spending in other areas or increasing taxation.

	Pros	Cons
Scottish government proposals • UK State pensions currently in payment to Scottish residents would be paid by the Scottish Government. • For Scottish residents of working age, the liability for all State Pensions earned to date would fall to the Scottish Government.	• This creates a known annual liability from Day 1 of an independent Scotland. • It is simple to establish and does not rely on incomplete data. • Administration would be simple; postcodes would determine the responsible paying authority.	• This does not reflect the split of benefit that has been accrued in the rest of the UK (rUK) and Scotland. • It allocates individuals to one jurisdiction, even if their residence on that day is temporary. This could generate significant future cross-border payments, on which possible currency fluctuations would affect pensioners' income.

The State Pension Age

The UK Pensions Minister introduced a range of proposals in the 2013 Pensions Bill for State Pensions. An increase in the State Pension Age at an earlier than previously scheduled date was included in those proposals with future independent reviews, approximately during each Parliament, of the scheduled increase implementation dates. These independent reviews would comment on the suitability of the proposed timetable and offer further recommendations.

	Pros	Cons
Scottish Government proposal • The introduction of the 2026-28 increase to State Pension Age would be reviewed. The Scottish Government would establish an independent review body to consider future increases based on life expectancies in Scotland.	• There is opportunity to establish a State Pension Age that reflects the longevity characteristics of Scotland's residents. • The Independent Review could consider an even longer term progression of State Pension Age increases based on Scottish-specific population projections. • The Independent Review could provide policy input as to the appropriate proportion of expected life, healthy or otherwise, for which State Pensions would be paid in Scotland.	• State Pension Age has long been a political nettle. There is a danger that a future government would use State Pension Age as a populist tool to avoid making difficult and unpopular long-term funding decisions. • A delay in accepting the 2026-28 increase may make future increases more difficult to implement, particularly within the early years of a newly independent Scotland. • Scotland would still have wide variations in life expectancies across the country and different socio-economic groupings.

Increases to the State Pension

Whilst the Scottish Government has set out some of its objectives in providing a Scottish State Pension, further clarity on what proportion of Scotland's GDP should be made available for pension payments would be welcomed. Increases to State Pensions have varied over time and have been linked to a variety of measures.

	Pros	Cons
Scottish Government proposal • For the term of the first post-independence Parliament, Scotland would retain the "triple-lock" increase, which is the greatest of earnings growth, inflation or 2.5%.	• Current expectations of pensioners, and those drawing near retirement, would be met. • The commitment would be reviewed by the end of the first Parliament. • Increases would reflect the cost of living, or wage increases in Scotland.	• A period of high inflation could lead to unanticipated payments. • There may be reluctance to remove the triple-lock in the future if deemed unpopular, even if it were appropriate.

The amount of the State Pension

The UK Pensions Minister introduced a proposal in the Pensions Bill to simplify the State Pension. The accrual of State Pension would be on a flat-rate and other ancillary pension benefits would be removed.

	Pros	Cons
Scottish Government proposal • Retain the move to the Single Tier Pension, but also retain the Pensions Credit; Savings and Guaranteed credits. The amount of the Single Tier Pension would be the greater of £160 p.w., or the level of the rUK Single Tier Pension at the time of independence.	• Pensioners would be no worse off than if they were in the rUK.	• There is a commitment to match the UK Government's pension amount, which may not reflect Scotland's circumstances. • The commitment to use a Scotland specific retirement age is not matched by a Scotland specific pension amount. • The proposal incorporates greater complexity into the amount pensioners would receive. • There may be less incentive for individuals to save for their own retirements.

Auto-enrolment in an independent Scotland

The background

The provision of UK pensions is undergoing a fundamental change. Between October 2012 and February 2018, employers will have to automatically enrol their employees into a pension scheme and make contributions for them (employees will also have to contribute). This is known as automatic enrolment (AE), and commenced in October 2012 with Britain's largest employers. Over the next 5 years the roll-out of AE will progress from the largest down to the smallest employers in Britain.

Employees will be able to 'opt-out' but will automatically be enrolled again periodically. This is intended to increase the overall level of pension savings in the UK and to address the pension savings 'gap'. The minimum level of contributions from both employer and employees will increase over time. Employers can use their existing pension schemes to meet these requirements provided they are of suitable quality, they can set up a new scheme or they can use 'NEST' (National Employment Savings Trust), which was set up by the government to support the introduction of AE.

Pros		Cons
Scottish Government proposal		
• The Scottish Government proposes to maintain the AE process. To assist employers a Scottish NEST equivalent would be established.	• This would provide continuity for employers and employees. • This would help to address the pension savings gap. • Operating under the same timescales and contribution levels would manage expectations. • Future contribution rates could be set to increase pension provision, or reflect Scottish needs. • There would be better opportunity to ensure consistent levels of pension savings between Scotland and rUK. • This would minimise any issues relating to cross-border companies.	• Much of AE will be concluded by the time of independence, so many Scottish companies would have plans already in place. • A Scottish NEST would be expensive to establish. • Consideration would have to be given to cross-border contributions given existing arrangements. • Future differing levels of contributions would affect either business competitiveness or cross border employment relations.

Cross border occupational pension schemes

What is a cross-border scheme?

In broad terms, under the current UK interpretation of cross-border activity, post-independence a pension scheme will be cross-border where there are members in both Scotland and rUK simultaneously accruing benefits.

What is a Scottish scheme?

The brief answer is that no one knows as there is no such definition, however, there are a number of factors that can be considered. It is not clear how the country of establishment of a pension scheme would be defined as schemes are currently registered on a UK-wide basis, but individual member state registration is likely to be necessary. Factors that could be relevant for determining this include:

- The main administrative base of the sponsoring employer;
- Whether the Governing Deed is written under Scots Law; or
- The location of the Trustee Company (if applicable); or
- The location of the scheme's membership.

What's the background?

There are over 6,300 funded defined benefit (DB) pension schemes in the UK. Nearly three quarters of these schemes continue to offer benefit accrual, although a large majority of those do not offer membership to new employees. A significant proportion of these schemes will have employees in both Scotland and rUK and would potentially be cross-border schemes.

Under existing UK legislation, a cross-border pension scheme is obliged to carry out annual actuarial valuations and to be fully funded within two years of each valuation. Almost without exception, UK pension schemes have to date taken steps to avoid becoming cross-border schemes and falling under this requirement. This is because, ordinarily, UK pension schemes carry out actuarial valuations every three years and have significant flexibility over the time horizon for being fully funded (on an ongoing basis).

What Scottish Independence might mean

As noted in the introduction, the subject of Europe, and an independent Scotland's relation to Europe, is important. Within pensions, the most important aspect is in relation to cross-border schemes. The Scottish Government has expressed a view as to what cross-border schemes could look like; however, the importance of the subject matter means that detail from the European Commission as to the exact nature of Scotland's relationship to Europe is also required.

This is as important a subject for rUK as it is for Scotland. Many employers based in rUK have Scottish employees. For those companies and their staff, a definitive view on this matter would be very welcome. As such, the matters highlighted within this section would apply to all post-independence cross-border schemes.

European developments

The European Commission is expected to release its revised IORP Directive later this year. Some of the matters of debate may be clarified by that paper, although that is not guaranteed.

What could independence mean and how could problems be resolved?

A range of practical issues would need to be addressed either through negotiation settlements or Scottish Government policies post-independence.

The impact of independence for cross-border schemes

	Pros	Cons
Scotland remains in the EU: • A UK pension scheme with employees is subject to the social and labour laws of another member state (or EEA country).	• Continuation of existing UK rules. • Enhanced employee benefit security due to more stringent funding requirements.	• All schemes with employees building up pension benefits (whether DB or DC) in both Scotland and rUK would become cross-border schemes. • Significantly higher numbers of schemes/sponsors would be subject to more onerous funding requirements, potentially reducing business growth. • There may be greater complexity, if Scotland issues its own sovereign debt, in determining those funding requirements. • Cross-border funding requirements may accelerate the closure of schemes to further accrual. • Greater contribution requirements would reduce corporation tax receipts for the Scottish (and rUK) government.

Scotland leaves the EU: • The Scottish Government would have the opportunity to set its own regulation for dealing with cross-border schemes.	• Develop a legislative framework that could best reflect the needs of the Scottish economy.	• Clarity needed on how any new legislation would retain the existing valuable features and protections for scheme members.

Protecting customers of insurance products

What could independence mean?

A significant range of practical issues need to be addressed, either through negotiation settlements, or through Scottish Government policies post-independence. Existing customer protection bodies currently have remits covering the United Kingdom and are all based primarily in London. In the event of Scottish independence, the Scottish insurance sector would require clarity for its customers to ensure that there were still one or more organisations in place to protect customer interests. It is important to understand what bodies would be in place and how these bodies would be paid for. The method by which these bodies are funded could have an impact on the jurisdiction in which financial services companies choose to carry out their operations including basing their head-offices.

An independent Scotland would have to decide how to regulate the customer-intermediary, intermediary-insurer and customer-insurer relationships discussed above. With a number of firms having invested and continuing to invest significantly in amending their business models to cope with the post Retail Distribution Review (RDR) environment, there will be a desire to understand anticipated advice regulations in an independent Scotland. An independent Scotland would also wish to minimise the risk of customers falling into the 'advice gap'.

What's the background?

The United Kingdom has a well-developed and regulated insurance industry, being the third largest worldwide and contributing £2.7bn in Corporation Tax revenues[1]. Scotland has contributed significantly to this position over the last three centuries, particularly in the field of life insurance and pensions; from the establishment in Scotland in the 18th century of what many consider the world's first actuarially based life insurance fund[2] to being 'home' today to some of the UK's largest life insurers and pensions providers. The insurance industry continues to be a strong employer within the Scottish economy (over 25,000 directly employed, amounting to 8.1% of UK's insurance industry's employees[3], plus sizeable indirect employment from associated legal and professional service firms).

Protection of insurance customers requires regulation in two areas:

1. Conduct risk – ensuring that companies operate in a way that is appropriate and fair to their customers
2. Prudential supervision – ensuring that companies have resources available to meet their obligations to customers

Additionally, any post-independence regulators would be expected to ensure markets operate efficiently which extends to enabling competition in the industry for customer benefit.

Financial services have complex products, about which customers often have limited knowledge, resulting in an asymmetry of information in the purchase of these products. The UK's financial services industry is supported by several regulatory and customer protection bodies. These include, but are not limited to, the Financial Conduct Authority (FCA), The Prudential Regulation Agency (PRA), the Financial Ombudsman Service (FOS) and the Pensions Regulator (tPR). The existence of these bodies provides

[1] UK Insurance Key Facts, ABI
[2] The Scottish Ministers' Widows Fund 1743 – 1993, St Andrews Press, Edinburgh
[3] Regional Contribution of UK Financial and Professional Services, theCityUK

customers of financial products with a level of protection and comfort that the companies with which they communicate adequately consider the customer's interests. These bodies are often paid for by levies applied to financial services companies within the UK.

The consequences and issues for the regulation of the Scottish and UK insurance industry should Scotland become independent need to be seen within the broader context of European and global regulatory change. Insurers across Europe have recently been working to implement new standards for risk governance and capital adequacy as set by the European Union (EU), known as 'Solvency II' (implementation is currently delayed until 2016). It should also be noted that the international Financial Services Board is looking to apply additional requirements to insurers, whom it defines as Global Systemically Important Insurers, which will impact at least one insurer with a large Scottish office. Again, this emphasises the importance of having clarity with regard to Scotland's relationship with the EU.

It should be noted that Scotland does not have a strong history of general insurance provision, unlike life insurance. Independence would be likely to mean that either London based companies would trade cross-border, or there would be new opportunities to establish a Scottish general insurance market. Similarly independence may mean different life insurers would approach cross-border selling in a fresh way. The IFoA cannot comment on how individual companies would react to independence.

Which bodies would have responsibility for regulation in an independent Scotland?

Possible solutions	Pros	Cons
Extend powers of existing rUK bodies.	• This would ensure continuity of existing customer protection. • It would avoid disparity in the level of customer protection - to customers in Scotland and rUK. • It is potentially cost-efficient. • It reflects that much UK regulation now emanates from the EU.	• It would be likely that additional legislation by both the Scottish and rUK governments would be required to empower these bodies. • Political sensitivities would remain, particularly if one government wished to introduce changes, but the other did not. • There would be an inability for the Scottish Government to tailor regulation for the Scottish market. • Much would depend on Scotland's status; i.e. if Scotland were not in the EU, but subject to EU regulation through UK regulation, it could lose out on potential benefits (e.g. access to cross-border markets).

Create new Scottish regulatory bodies:		
• Funding for these bodies could be sourced centrally from taxpayer funds or could be funded via levies on financial services companies/products.	• This would offer the flexibility to set levels of customer protection in-line with the specific requirements of customers in Scotland or to reflect rUK. • It would offer the potential to arrange financial service legislation in a different way, e.g. a unitary regulator. • Monitoring a smaller number of large insurers may improve regulatory oversight. • Outside the EU, Scotland could set its own regulatory basis, with potential to independently implement a Solvency II-like structure tailored to the local market.	• It would be likely that additional industry overheads, potentially borne by a small number of institutions, would be generated. • As a smaller member state of the EU, Scotland could face difficulty in influencing EU regulation. • If Scotland were not a member of the EU, Solvency II could lead to the EU imposing requirements on a Scottish headquartered company that is undertaking business in the EU (e.g. in the rUK). • It would be important to ensure that adequate consumer protection for cross-border policyholders of a Scottish institution in the rUK was covered by an appropriate customer protection body and vice versa.

Pension protection

Scottish Independence: How can pension benefits be protected?

The United Kingdom presently offers a variety of protections to pension benefits. The format of these protections depends on the source of the benefit. Broadly there are two types of private pension provision:

- Occupational pension provision
- Personal pension provision

Most occupational pension provision is based on the principles of trust law whereby an employer sets up a trust to administer the benefits from that employer's pension scheme. There are cases of multi-employer schemes. Provision tends to be in the form of defined benefits (DB) or defined contribution (DC).

Personal pension provision is based on a contract, with an individual holding an investment effectively in his or her own name, rather than pooled with others in an occupational scheme. This may be via an insurance company or in the form of a self-invested policy.

The protection of occupational pensions

Members receive a number of protections within the occupational pension structure. Most of the specific comments in this section apply to DB schemes, however, as AE becomes more significant, the protection of benefits from DC schemes will become more important. It should be noted that the current regulatory framework is set up to achieve that objective, so it would be important to maintain that position in an independent Scotland.

Assuming that current legislation remains in place, in the event of a solvent employer winding up a pension scheme, the employer is required to fund the scheme to allow the trustees to buy-out the accrued benefits in full with an insurer. Given there is no reliable indicator of how many Scottish schemes exist, it would be important to establish that a Scottish insurance market had the appropriate capacity to provide that service.

In the case of employer insolvency, the DB scheme may enter the Pension Protection Fund (PPF), given certain circumstances. It should be noted that PPF compensation does not provide full benefits. If schemes' assets are insufficient to buy-out a prescribed level of benefits, the scheme can enter the PPF and members subsequently receive PPF compensation.

The Scottish Government's pension paper suggests that an independent Scotland could continue with the current PPF, or establish a Scottish PPF.

	Pros	Cons
Continue with the existing PPF:	• This would minimise disruption. • It would avoid the problems associated with dealing with existing 'Scots' in a 'non-Scottish' PPF. • It would benefit from economies of scale.	• Agreement would need to be reached on the terms of use. • There could be a risk of cross-subsidy between Scots and non-Scots, e.g. with different mortality patterns. • If Scotland adopted a different currency, there would be a currency mismatch, which the PPF might not accept. • The PPF could charge different levies in different jurisdictions. • If the PPF required additional Government funding, the calculation of Scotland's share could be complex, or problematic.
Establish a Scottish PPF:	• This would avoid any cross subsidies in a joint Scottish/rUK PPF that were not in Scotland's favour, e.g. lower mortality. • It would mean that a change in the Scottish currency was not a problem.	• There are certain fixed costs in running such an organisation which make it likely to be more expensive in levies to schemes than continuing with the existing PPF. • With a smaller population of schemes there is likely to be a greater concentration of risk.

Protection of Personal Pensions

The UK currently offers a degree of protection for personal pensions through the Financial Services Compensation Scheme (FSCS). Currently where pension provision is via an insurance company, this protection is a maximum of 90% of the amount invested, with no upper limit.

The options are broadly similar to those for occupational pension provision. The advantages and disadvantages in each option are of a similar nature too.

	Pros	Cons
Continue with the existing arrangement: • As part of an independence treaty the Scottish government could negotiate for Scotland to be allowed to participate in the existing FSCS.	• This would allow the existing safety net to continue. • It would mean that individuals' protections would not change.	• Agreement would need to be reached between both governments. • There would be potential for cross subsidies in such an arrangement. • If Scotland changed its currency it would create complexity.
Establish a Scottish FSCS: • The Scottish government could set up its own, similar FSCS.	• This would allow the level of compensation to be set at an appropriate level for Scotland.	• There are fixed costs which could make this a more expensive option than participating in a cross-border arrangement. • There is a political risk if a UK scheme improves compensation but this is not mirrored in Scotland. • If a compensation scheme only allows 'Scots' to be compensated this could discourage cross border investment.

Summary and conclusions

The Institute and Faculty of Actuaries will work with government whatever the outcome of the independence referendum. As a representative professional body with a Royal Charter, we have a public interest duty to raise questions that we believe are pertinent for actuaries and users of actuarial services. Our view is that the public interest is best served by informing the debate on these important issues including insurance, pensions, financial services regulation and future growth of the sector.

Knowing the status of an independent Scotland in relationship to the European Union would provide clarity and answers to some of the questions raised in this paper, not least the future currency of an independent Scotland or the funding requirements for any cross-border pension schemes.

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